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May 23, 2003

BY HAND

David R. Eichenlaub
Assistant Director, Economics
Division of Economics and Finance
State Corporation Commission
1300 East Main Street, Fourth Floor
Richmond, Virginia 23218

Re: **SCC Report on the Status of Competition in the Electric Industry**

Dear Mr. Eichenlaub:

Thank you for your letter of April 16, 2003 inviting comments for the State Corporation Commission's ("Commission" or "SCC") third annual report to the Legislative Transition Task Force ("LTTF") and the Governor under the Virginia Electric Utility Restructuring Act ("Act"). Section 56-596 B of the Act requires the Commission to report on (1) the status of competition in Virginia; (2) the status of development of regional competitive markets; and (3) recommendations to facilitate effective competition in Virginia as soon as practical. In addition, your letter asks for responses to several questions for purposes of the report. On behalf of Appalachian Power Company, d/b/a American Electric Power ("Company" or "AEP"), this letter will respond to the statutory subjects of the report and the questions in your letter.

STATUS OF COMPETITION IN VIRGINIA

The Company reported last year that: "As of January 1, 2002, all of AEP's Virginia customers have a choice of retail suppliers of electric generation services, and the Company stands ready to respond to customers' choices as alternative supply arrangements may become advantageous to them." However, the Company's most current information is that competitive retail electric generation suppliers have not entered the Virginia retail market, perhaps due in part to structural features of the Act. Due to this absence of generation supplier entry, customers have not had a practical opportunity to exercise their legal option to select alternative generation suppliers.

The implementation of the requirements for retail customer choice are, for the most part, in place and in compliance with the Commission's retail choice rules. Rates are unbundled, and incumbent utilities either operate in a functionally separate manner as

required by the Commission or have separated or divested their generation assets and operations to separate legal entities. Other factors are slowing progress to widespread switching of customers among alternative generation suppliers.

The expectations created by the Act from its passage in 1999 have been that retail competition would develop during the period between January 1, 2002 and July 1, 2007, and could possibly develop such that capped rates and wires charges could be ended as early as January 1, 2004. Although much of that period remains, a significant portion of it has passed without progress toward the vigorous competition among generation suppliers envisioned in the Act. In addition, a critical element of successful implementation of the Act, entry of Virginia's major utilities into an independent regional transmission entity ("RTE"), has been substantially delayed until well into the period ending July 1, 2007.

While there appears no need for immediate action in the 2004 Session of the General Assembly, the Company has a growing concern that the development of retail competition in Virginia will require closer monitoring by the LTTF. Unless there is significant progress over the next twelve to fifteen months toward fulfillment of the expectations in the Act, including resolution of the Virginia RTE approvals, the LTTF and the General Assembly may be required to consider appropriate changes in the Act.

STATUS OF REGIONAL COMPETITIVE MARKETS

As the Company noted last year: "Open access transmission services and broad access to energy suppliers remain preconditions necessary to allow robust competition to develop for Virginia electricity customers." However, the development of robust, effective wholesale competition has been affected by a lack of progress in implementing RTEs as anticipated in the Act. AEP and its affiliates have sought to join an appropriate RTE since 1999. After initially approving most aspects of, but then ultimately rejecting, AEP's request to join the Alliance Regional Transmission Organization, the Federal Energy Regulatory Commission ("FERC") has now approved AEP's entry into PJM Interconnection, LLC ("PJM").

The Company has an application pending in Virginia for approval to transfer functional control of its transmission facilities to PJM. RTE participation is a fundamental element of the Act, recognized from the beginning as essential to the development of robust competition, that should now be resolved in Virginia promptly.

RECOMMENDATIONS TO FACILITATE EFFECTIVE COMPETITION

The Company recommends continued efforts to implement the Act, including prompt decisions on RTE participation. In light of the certainty concerning PJM and its market structure and operation, and the fact that the FERC has addressed in the "white paper" many of the Commission's jurisdictional concerns on the original SMD proposal, AEP would encourage the Commission to address, more promptly than was previously planned, AEP's RTE application that is currently pending before the Commission.

In its comments last year, the Company said: "...the Commonwealth continues to have an opportunity to observe changes in economic conditions and developing competition in energy markets before further changes in the balanced approach taken in the Restructuring Act are considered." That opportunity remains today, but it is diminishing. Contrary to the expectations in the Act, substantial progress toward robust competition will not likely occur by January 1, 2004, and perhaps not before July 1, 2007. On the other hand, the Act is complex, and every amendment proposed by one specific interest can lead to countervailing proposals by other interests. Careful study by the LTTF and timely actions by the Commission with respect to RTE approval should be given priority over attempts at immediate, issue-by-issue legislation that could have unintended consequences. If the Commonwealth is to change direction through legislation, that change should be based on a comprehensive reconsideration of the expectations embodied in the Act.

Attached to this letter are responses to the questions contained in your letter of April 16, 2003. On behalf of the Company, thank you for the opportunity to provide these views to you, the Commission, and the recipients of the Commission's report.

Sincerely,

A handwritten signature in dark ink, appearing to read "Barry L. Thomas". The signature is fluid and cursive, with the first name "Barry" being more prominent than the last name "Thomas".

Barry L. Thomas
Director, Regulatory Services VA/TN

BLT/cde

**AEP COMMENTS ON
SCC REPORT ON THE STATUS OF COMPETITION IN THE ELECTRIC INDUSTRY
2003**

RESPONSES TO QUESTIONS IN THE STAFF LETTER OF APRIL 16, 2003

1. What are the current obstacles to the development of a robust competitive retail electricity market for residential customers? For commercial and industrial customers? How can these obstacles be overcome?

RESPONSE:

The Company is concerned that competition has failed to develop in Virginia. It has been suggested that current obstacles to development of widespread customer switching of generation suppliers are wires charges and utility rates capped at levels that are, or are becoming, unrealistically low. Another obstacle has been the uncertainty created by controversy surrounding, and the lack of progress toward, RTE development in Virginia. The Company does not believe that legislation is necessary in the 2004 Session of the General Assembly. However, continued lack of progress toward robust retail competition could trigger the need for a broad re-examination of the entire Act. Moreover, narrow legislative proposals to amend individual provisions of the Act, as have been discussed by others in the past, could necessitate a re-examination of many other provisions. Capped rates, wires charges, RTE participation and other critical provisions of the Act should not be excluded from such a broad re-examination, in the Company's view.

2. With respect to potential obstacles, what is the outlook for future natural gas prices and the impact on wholesale electricity prices and a competitive retail market? Please comment on the postulation by several natural gas industry experts of a growing structural demand/supply imbalance with demand outstripping supply over the next several years. What actions, if any, could be taken to mitigate the potential impact of an over-dependence on a single fuel source?

RESPONSE:

The Company does not have sufficient information to attempt to answer this question from the perspective of other competitors or fuel suppliers. In any event, the inquiry should be broader. AEP has a diverse fuel mix, which includes coal, natural gas, nuclear, wind, hydro, and fuel oil, and is not heavily reliant on natural gas-fired capacity to serve its Virginia electricity customers. Volatility in natural gas prices is not the only determinant of the overall variation in fuel prices or wholesale electricity prices. Supply, demand, transmission congestion, generation and transmission outages, and weather are all factors that play a role in determining the price of electricity. AEP has risk management practices in place so as markets develop and change, fuel procurement can be modified accordingly.

3. In light of recent legislation, how can the Commonwealth be assured of a continuing reliable electricity system when control of transmission is governed by an RTO? What factors should be considered during the cost/benefit analysis required prior to Commission approval?

RESPONSE:

AEP believes that its participation in a RTO, specifically PJM, will enhance the reliability of AEP's transmission network. For instance, PJM will be able to plan and schedule generation and transmission line outages for maintenance over a large region in a coordinated manner, which will reduce the potential for congestion and short term reliability problems. Also, with AEP's participation, PJM will be able to use the most cost-effective and reliable combination of generation across a large region to balance the entire regional grid and adjust the dispatch economically to relieve congestion and enhance reliability. PJM will be able to internalize many of the critical loop flows that impact reliability and congestion and use regional dispatch to manage congestion created by loop flows. This will be important for the portion of AEP's system located in Virginia. Since the Allegheny Power and Dominion Virginia Power systems, along with AEP, will be part of PJM, PJM will be better able to manage congestion by internalizing within PJM needed redispatch and transmission operation. The market-based redispatch to alleviate congestion will mitigate the need for the existing NERC TLR process, thus further improving the reliability of transactions. Furthermore, PJM has a long-term regional planning process that is open, transparent, and focused on the public interest and consumer benefits. This process ensures continued reliability and promotes new competitive alternatives to alleviate congestion and therefore enhance reliability.

AEP will provide information regarding costs and benefits of RTE participation as part of its pending RTE case. That information will address factors such as impacts on power supply costs for retail customers and the costs of participating in an RTE, including RTE administrative costs. A complete discussion of these factors will be provided when AEP submits its cost/benefit data.

4. Later this month, the Federal Energy Regulatory Commission is expected to issue its "white paper" addressing certain issues debated the past several months regarding Wholesale Electric Standard Market Design (SMD). Additionally, the Department of Energy is expected to issue the results of its cost/benefit analyses of the impacts of SMD. Please provide your initial thoughts and reaction to such releases and identify any significant issues of concern.

RESPONSE:

AEP is encouraged that FERC made in its "white paper" significant changes to the original SMD NOPR to address concerns raised by AEP, state regulators, and other stakeholders. For instance, FERC has supported regional flexibility on market design elements and addressed jurisdictional issues that the Virginia Commission and others have raised. AEP currently plans

to submit comments on the "white paper" and will address at that time both the areas we support and our continuing concerns with the proposal. Also, AEP intends to participate with other parties, including state commissions such as the SCC, in stakeholder discussions at PJM regarding issues concerning implementation of SMD.

DOE's recently issued cost/benefit report indicates that, in general, retail customers across the country will benefit from FERC's SMD proposal, although customers in some areas will experience higher costs in the short run. The DOE's study, like other studies on SMD, is significantly dependent on the assumptions used in the study.

5. Are the Commission's Rules Governing Retail Access to Competitive Energy Services conducive to promoting effective competition in the Commonwealth? If not, how should they be modified? Is there any way in which these rules can or should be improved, in any event?

RESPONSE:

In its comments for the Commission's competition report last year, the Company noted that the degree to which Commission rules might have discouraged competitive entry is unclear. It remains unclear. However, the Company has insufficient information to answer this question from the perspective of a competitive generation supplier. The burden is on potential new entrants to explain any reticence to enter Virginia based on the Commission's rules.

6. What should be the level of consumer education when the program is resumed on July 1, 2004? Should it be as visible, more visible or less visible than when the campaign was suspended? Upon resumption of the campaign, what focus, theme or message should be communicated? Since TV advertising is the most expensive component of the program, what level of TV advertising should be included in the resumption of the campaign?

RESPONSE:

The Company explained last year that: "After a long history of customer reliance on a single provider of electricity supply, there will likely be no successful customer choice program without customer education." While the Company understands the budget and other considerations that have made the program difficult and caused its temporary suspension, customer education remains essential. To achieve effective results, reactivation of the program should be scheduled closer to the expected onset of widespread customer choice, based on the LTTT's assessment of progress toward a competitive retail market.

7. Are there any other actions that have been taken or are being considered in other states that may be used to advance competitive activity in Virginia?

8. Do you have any ideas that have not been tried elsewhere that may facilitate competitive activity in Virginia?

RESPONSE TO QUESTIONS 7 AND 8:

In the Company's view, it is incumbent upon potential competitive generation suppliers to explain their difficulties in entering Virginia. There may be actions taken or considered in other states, or other concepts that have not been tested elsewhere, that competitive suppliers consider promising and encouraging to their entry into the Commonwealth. AEP has insufficient information to suggest changes that might encourage competitive suppliers. However, any proposed changes should provide for customer switching of generation suppliers on a sound economic basis rather than on regulatory calculations intended to create artificial "headroom" between market prices and utility rates.